BREXIT, THE STORY SO FAR

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The United Kingdom (UK) voted to leave the European Union (EU) by a narrow margin of 52% to 48% on 23 June. The UK has been a member of the 28-nation single market for 43 years (it is not part of the 19-nation bloc that uses the euro as a currency, often called the Eurozone). Prime Minister David Cameron called the referendum before the 2015 general election as a ploy to retain Euro-sceptic votes for his Conservative Party. It won him the election but has now backfired badly.

Political risks

Brexit (a British exit from the EU) is likely to negatively impact the British economy because the way forward is unknown. No country has ever disentangled itself from the European Union. Britain will have to manage this while negotiating a new trade relationship with the EU. This could take years. In the meantime, businesses might opt to postpone investment decisions until there is more clarity. David Cameron who campaigned for the Remain camp has stepped down as Prime Minister in the wake of the defeat, with Theresa May taking the reins as head of the Conservative Party and Prime Minister. The leader of the UK Independence Party and key Brexit campaigner Nigel Farage stepped down while the Labour Party has also been thrown into turmoil.

Bad for the UK, but not necessarily for the rest of the world

Having said all that, Brexit is unlikely to fundamentally change the outlook for the global economy. The UK economy is likely to suffer, and therefore shave a few basis points off global growth. If there is persistent financial market volatility, the impact could be worse.

The longer-term impact will largely depend on the kind of trade relationship the UK negotiates with the EU and other countries. If there is a Brexit, the UK will probably push for the "Norway model", maintaining a free-trade relationship with the EU without being a member. However, this model links trade access to free movement of people, while immigration was the key issue for the Leave campaign.

Theresa May campaigned for the UK to remain part of the EU, but has said she will respect the outcome of the referendum, even though it is not legally binding. However, until the UK formally submits the so-called Article 50 notice to leave the EU, it is still a member. European leaders have indicated they want things to move swiftly, but they cannot force the UK out.

The concern for the EU leadership is that the Brexit vote could provide a further boost to Euro-sceptic parties across the continent. The leaders of other EU members will therefore be torn between making life extremely difficult for the British during the negotiations (to make an example of them), and giving concessions that will avoid unnecessary economic turmoil.

Market volatility, but no crash

While the Brexit events are still playing out, this has not been a Lehman-like moment. Credit markets haven't seized up and the Bank of England (and other central banks) is ready to act as and when required.

Markets were roiled by the referendum outcome, as it came as a surprise. In the days leading up to the referendum, polls appeared to swing in favour of the Remain vote. Equity markets fell on the day of the referendum result, but broadly recovered. Rather than a widespread sell-off across all markets, particular pockets have been hardest hit:

- The pound, which fell to a three-decade low against the dollar. Over time, a weaker pound should be good for UK exporters, tourism and import-competing businesses. The FTSE 100 equity index bounced back quickly after the Brexit sell-off, since most of its constituents benefit from a weak pound (much like the JSE All Share Index benefits from a weak rand). Rather than feeling sorry for the British, one should feel sorry for the Japanese, whose currency has surged, squeezing export incomes and putting downward pressure on inflation.
- UK property shares (on expectations that financial businesses will relocate out of London to serve European markets). Several commercial property funds had to suspend withdrawals, reminiscent of 2008. The problem with these types of funds is that they hold very illiquid unlisted assets (buildings and warehouses that can take months to sell even in normal times) but offer daily liquidity to their investors. The big concern is that London's status as global financial centre is diminished, reducing demand for property. These fears are probably overblown, as London was a global financial centre long before it joined the EU, and will remain one for reasons of language, infrastructure, skills, law and professional networks.
- Eurozone (particularly Italian) bank shares as the risk of a disintegration of the Eurozone increases again at a time when banks are struggling with rising bad loans. Britain exiting the EU will be a much simpler affair than, for instance, an Italian exit, since the UK retained its own currency while Italy would have to redenominate all its debts and assets in a new, presumably weaker currency.

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Bond yields plunged

Meanwhile, despite having its AAA credit rating downgraded, UK government bond yields fell (i.e. bond prices rose) to record low levels. The benchmark 10-year UK government bond yield fell below 1%, while the decline in the bond yields of other developed countries accelerated. German, Japanese and Swiss government bond yields fell deeper into negative territory. Brexit has not resulted in an interest rate shock; instead, long-term interest rates fell.

Impact on South Africa depends greatly on the rand

Which brings us to South Africa. The main channel through which Brexit impacts South Africa is financial market sentiment. A weaker UK economy will absorb less South African exports and send fewer tourists over time. But the big immediate risk is that a shift in global risk appetite will cause the rand to weaken, pushing imported prices up and resulting in higher interest rates. However, despite equity market volatility, the rand has so far remained remarkably resilient. In fact, at the time of writing (mid-July), the rand had strengthened 6% against the US dollar and 16% against the pound. This provides breathing room for the local consumer burdened by high inflation and rising debt-servicing costs.

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